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June 2007

# DEFENSE CONTRACTING

## Improved Insight and Controls Needed over DOD's Time-and- Materials Contracts



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## Why GAO Did This Study

Under time-and-materials contracts, payments to contractors are made based on the number of labor hours billed at hourly rates and, if applicable, other direct costs. Because of the risk they pose to the government, their use is supposed to be limited to cases where no other contract type is suitable. GAO was asked to identify trends in the Department of Defense's (DOD) obligations under time-and-materials contracts; analyze what DOD is buying under these contracts; assess why DOD is using them and whether actions are being taken to ensure that they are used only when no other contract type is suitable; evaluate DOD's monitoring of contractor performance; and determine the differences between the labor rates prime contractors bill DOD and the rates in their subcontracts. GAO reviewed 82 time-and-materials contracts, agreements, and orders and examined prime contract and subcontract labor rates on 12 additional contracts or agreements.

## What GAO Recommends

GAO is recommending that DOD require more diligence in justifying the use of certain types of time-and-materials contracts, analyze the use of time-and-materials on indefinite-quantity contracts to ensure that it does not become the default contract type, and require monitoring plans to reflect the risks inherent in this contract type. In written comments on a draft of this report, DOD concurred with the recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-07-273](http://www.gao.gov/cgi-bin/getrpt?GAO-07-273).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Katherine V. Schinasi at (202) 512-4841 or [schinasi@gao.gov](mailto:schinasi@gao.gov).

June 2007

# DEFENSE CONTRACTING

## Improved Insight and Controls Needed over DOD's Time-and-Materials Contracts

### What GAO Found

DOD's reported obligations under time-and-materials contracts increased from almost \$5 billion in 1996 to about \$10 billion in 2005. But this dollar amount is understated because DOD has not been coding contract type for orders placed under federal schedules (e.g., General Services Administration's schedule contracts). The accuracy of reported time-and-materials dollars should improve starting with fiscal year 2007 because DOD transitioned to the federal government's procurement information system, which requires contract type to be coded for every order.

Over 75 percent of DOD's reported time-and-materials obligations are concentrated in three service categories: professional, administrative, and management support services; information technology and communications; and equipment maintenance and repair. Over 80 percent of these obligations are against task orders. DOD is also using time-and-materials contracts to acquire contract services to supplement the government workforce. Examples include intelligence support, advisory and assistance services, and systems engineering.

DOD is turning to time-and-materials contracts because they can be awarded quickly and labor hours or categories can be adjusted if requirements are unclear or funding uncertain. Contracting officers' written determinations almost never included a rationale as to why a less risky contract type could not be used, and little attempt was made to convert follow-on work to a different contract type. Recent changes to federal acquisition regulations to allow for commercial services to be procured on a time-and-materials basis impose more stringent justification requirements, but most of the revisions do not apply to non-commercial procurements.

Even though time-and-materials contracts call for appropriate government monitoring of contractor performance, there were wide discrepancies in the rigor with which monitoring was performed and most of the contracts and orders GAO reviewed did not include documented monitoring plans. In general, monitoring was based on contractor-provided monthly status reports showing the contractor's activities and amount of funds expended.

Under some time-and-materials contracts, the prime contractor charged DOD at prime contract hourly rates for subcontracted labor. According to the Defense Contract Audit Agency, this practice can result in the prime contractor earning additional profits. GAO's analysis of billing rates under 13 contracts and agreements showed that when the prime contractor charged prime contract hourly rates for subcontracted labor, the difference between the prime's rates and those in their subcontracts ranged from negative 40 percent to 192 percent, with most in the 6 to 53 percent range. Recent revisions to federal acquisition regulations will mitigate this practice for certain types of acquisitions.

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## **Abbreviations**

COR	Contracting Officer's Representative
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DFAS	Defense Finance and Accounting Service
DIA	Defense Intelligence Agency
DISA	Defense Information System Agency
DOD	Department of Defense
FAR	Federal Acquisition Regulation
FASA	Federal Acquisition Streamlining Act of 1994
GSA	General Services Administration
NIH	National Institutes of Health

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**United States Government Accountability Office**  
**Washington, DC 20548**

June 29, 2007

The Honorable Carl Levin  
Chairman  
The Honorable John McCain  
Ranking Member  
Committee on Armed Services  
United States Senate

The Department of Defense (DOD) uses time-and-materials and labor-hour contracts to acquire billions of dollars in services annually. Under these contracts, payments to contractors are based on the number of labor hours billed at a fixed hourly rate—which includes wages, overhead, general and administrative expenses, and profit—and the cost of materials if applicable. Services acquired under time-and-materials and labor-hour contracts span a breadth of activities—from administrative support and intelligence analysis to the installation of data and communications networks and maintenance of multimillion-dollar DOD weapon systems. These services can be provided by a single individual from a company or by companies utilizing scores of subcontractors. Time-and-materials and labor-hour contracts are considered high risk for the government because they provide no positive profit incentive to the contractor for cost control or labor efficiency. A contractor operating under a time-and-materials contract could conceivably work less efficiently so that more hours could be charged to the government. Thus, the onus is on the government to prevent wasteful spending by monitoring contractor performance to ensure that the contractor is efficiently performing the work and effectively controlling costs. Even with appropriate monitoring, however, the government is not fully protected because contracting officers may not reduce payments for hours actually worked when, in their opinion, the work was performed inefficiently. Finally, federal regulations require contracting officers to justify in writing that no other contract type is suitable before using a time-and-materials contract.

At your request, we reviewed DOD's use of time-and-materials contracts. Specifically, we (1) identified the overall trends in DOD obligations under time-and-materials and labor-hour contracts; (2) analyzed what DOD is buying under these contracts; (3) assessed the factors contributing to the department's use of time-and-materials and labor-hour contracts and whether actions are being taken to ensure that they are only used when no other contract type is suitable; (4) evaluated DOD's monitoring of

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contractor performance; and (5) for selected contracts, determined the differences between the labor rates prime contractors charged DOD and the labor rates in their subcontracts. In this report, we use the term “time-and-materials contract” to refer to both time-and-materials and labor-hour contracts and agreements,<sup>1</sup> unless otherwise noted.

To identify trends in the use of time-and-materials contracts, we analyzed data on all obligations for fiscal years 1996 through 2005 from DOD’s procurement information system—the DD350 database. The 2005 data was the most recent available when we performed our analysis. During the course of our review, we discovered a potentially significant underreporting of time-and-materials contracts in this database. To address this limitation, we developed a methodology to estimate the magnitude of the gap. The other key DD350 contract information that we used to select our contracts for review was present in the contract files we examined. The system’s information, except for the time-and-materials coding issue, was deemed sufficiently reliable for our purposes. We also used DD350 data to analyze what types of services DOD is buying under time-and-materials contracts. To obtain more detailed information on services procured under specific contracts, to assess the factors contributing to DOD’s use of this contract type, and to evaluate DOD’s monitoring of contractor performance, we conducted an in-depth review of 28 time-and-materials contracts, agreements, and orders from among those identified in DOD’s database as active in fiscal years 2004 and/or 2005. Twenty of the 28 were DOD contracts and the remaining 8 were under other agencies’ contracts. None were coded as commercial acquisitions, but DD350 data for three of the non-DOD contracts did not indicate whether they were commercial or non-commercial acquisitions. We made our selection taking into account dollar value, military organization, location of the buying activity, and type of contract. For contracts or agreements that allowed DOD to place individual orders for services (such as the General Services Administration’s (GSA) federal supply schedules or multiple award schedules),<sup>2</sup> we also selected time-and-materials orders for review. In many cases, these contracts also permitted orders to be issued using contract types other than time-and-materials. In all, we reviewed a total of 82 contracts, agreements, and orders. For each, we reviewed the contract file and collected

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<sup>1</sup> Agreements include blanket purchase agreements and basic ordering agreements.

<sup>2</sup> Under the GSA schedules program, GSA establishes long-term governmentwide contracts with commercial firms, and agencies place orders under these contracts.

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documentation related to the choice of contract type and monitoring of contractor performance. We interviewed the contracting officer and the individual responsible for the monitoring. Although our sample size did not allow us to develop statistical estimates that would enable us to project our results to the entire universe of DOD's time-and-materials contracts, we identified recurring issues related to DOD's use and management of time-and-materials contracts, regardless of the contract dollar value or buying activity.

To determine the differences between the rates prime contractors charged the government for subcontracted labor and their own prime contract rates, we selected, in addition to 1 blanket purchase agreement from our sample of 28 contracts, agreements, and orders that permitted this billing practice, an additional 12 (6 blanket purchase agreements and 6 large service contracts) for further review. In all, we analyzed 24 orders and 628 associated labor rates under these 13 contracts and agreements. We reviewed contract clauses, contractor proposals, subcontracts, and other documents related to the contracts and contacted prime contractor representatives to obtain more information on the subcontract labor rates. We also examined Defense Contract Audit Agency (DCAA) audit reports issued between December 2004 and November 2006 that are related to DOD's use of this billing practice.

Appendix I contains additional details on our scope and methodology. We conducted our review between February 2006 and May 2007 in accordance with generally accepted government auditing standards.

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## Results in Brief

DOD's reported obligations under time-and-materials contracts have nearly doubled, from almost \$5 billion in fiscal year 1996 to about \$10 billion in 2005. This increase was at a somewhat greater rate than the overall rise in DOD's spending on services. But the dollar amount is understated because the reported dollars did not include DOD's time-and-materials orders placed under federal schedules, such as GSA's schedules program. Because DOD spends billions of dollars a year on schedule orders, the unreported time-and-materials dollars are likely to be substantial. The data were not available because defense acquisition instructions and procedures, starting in 1997, directed officials not to specify contract type—such as time-and-materials—for schedule orders in DOD's procurement information system. The accuracy of reported time-and-materials dollars should be improved starting in fiscal year 2007, because that is when DOD transitioned to the federal government's

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procurement information system, under which users are required to code contract type for schedule orders.

Over 75 percent of DOD's time-and-materials obligations, as reported in DOD's procurement information system, are concentrated in three service categories: professional, administrative, and management support services; information technology and communications; and maintenance, repair, and rebuilding of equipment. Our reviews of contract files and discussions with DOD officials showed that DOD is also using time-and-materials contracts to acquire contract services to supplement the government workforce. Examples included subject matter experts in the intelligence field, systems engineering support, and advisory and assistance services. The workforce increasingly reflects a "blend" of government and contractor personnel. Government personnel are finding themselves working side-by-side with contractors, often performing similar roles.

Contracting and program officials frequently failed to ensure that time-and-materials contracts were only used when no other contract type was suitable. According to DOD officials, the main reasons time-and-materials contracts are used are the speed with which contracts can be awarded and the flexibility they provide in adjusting labor hours or labor categories in light of changing priorities, unclear requirements, or funding uncertainties. Most of the written determinations we examined did not include a rationale showing why another contract type could not be used instead. For some task orders, no determination had been prepared when required by ordering guidance for the underlying contract. Further, with a few exceptions—such as a Navy contract for aircraft upgrades that changed from time-and-materials to fixed-price once sufficient knowledge about costs was attained—we found that little effort had been made to convert follow-on work to a less risky contract type when historical pricing data existed, despite guidance to do so. In February 2007, federal acquisition regulation revisions implementing the new provisions in the Services Acquisition Reform Act of 2003 pertaining to the use of time-and-materials contracts for commercial acquisitions went into effect. The revisions require more stringent justifications for the use of time-and-materials contracts, including a requirement to justify their use at the task order level, but most of the changes apply only to commercial acquisitions.

Even though time-and-materials contracts call for appropriate government monitoring of contractor performance, we found inconsistencies in the rigor with which the monitoring occurred. Most of the contracts and orders we reviewed did not include documented plans for monitoring, as

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required. Such plans are intended to assist program officials and contracting officers' representatives in knowing what contractor activities they should be monitoring and how they should monitor them. In general, contracting officers' representatives performed their monitoring based on information that contractors provided about the status of ongoing work and "burn rates," or how quickly the money was being spent. In a few instances though, we found plans and reporting requirements, designated performance monitors, or evidence that program officials had actively monitored spending in labor categories. Some contracting officers obtained timesheets along with billing submissions, providing program managers with the necessary information to closely monitor labor hours according to specific labor categories.

DOD time-and-materials contracts typically allow prime contractors to bill DOD in one of four ways for subcontracted labor, one of which involves the prime charging the government for subcontract labor at the prime contract labor rate. According to DCAA, this practice can result in the prime contractor earning additional profit. Indeed, our analysis of billing rates under 13 contracts showed that when the contract allowed the prime to charge its own hourly rates for subcontracted labor, the differences between the prime contract rates and those in subcontracts ranged from negative 40 percent to 192 percent, with most in the 6 to 53 percent range. In addition, DCAA has questioned costs pertaining to subcontractor billing. In one case, DCAA found a prime contractor billed DOD for subcontracted labor at rates that ranged from 20 to 95 percent higher than the rates the primes paid their subcontractors. An interim rule to DOD's acquisition regulations supplement effective in February 2007 requires the prime contractor to propose separate labor rates for itself and its subcontractors for non-commercial, competitively awarded acquisitions under time-and-materials contracts, but—like new federal acquisition regulation provisions that apply governmentwide—does not require separate rates for commercial acquisitions.

We are recommending that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to require a similar level of justification for use of time-and-materials for non-commercial services as is now required for commercial acquisitions. We are also recommending that DOD analyze the use of time-and-materials orders under indefinite-quantity contracts to ensure that it does not become the default contract type when other types of orders are also allowed. Finally, we recommend that plans outlining government monitoring of contractor performance under time-and-materials contracts should include specific activities needed to ensure adequate oversight under this contract type. In its

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written comments on a draft of this report, DOD concurred with the recommendations. DOD's comments are printed in their entirety in appendix II of this report.

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## Background

Federal agencies, including DOD, can choose among different contract types or pricing arrangements, including time-and-materials contracts, to acquire products and services. This choice is the principal means that agencies have for allocating cost risk between the government and the contractor. Various contract types can be employed to meet the government's needs. For example, time-and-materials can be used in conjunction with stand-alone contracts; indefinite-quantity contracts, including those under GSA schedules; blanket purchase agreements; or basic ordering agreements. These choices are illustrated in figure 1.

**Figure 1: Contract Types**

CONTRACT TYPES			
Stand-alone contracts	Indefinite-quantity contracts (also known as task order contracts)	Basic ordering agreements	Blanket purchase agreements
Do not allow for individual orders to be placed against the contract.	Provide for an indefinite quantity, within stated limits, of products or services during a fixed period. Government places orders for individual requirements under these contracts. GSA schedule contracts are often indefinite-quantity contracts.	May be used to expedite contracting for uncertain requirements for products or services when specific items, quantities, and prices are not known at the time the agreement is executed. Basic ordering agreements are not contracts.	Are a simplified method of filling anticipated repetitive needs for products and services by allowing agencies to establish “charge accounts” with qualified vendors. These agreements may be established under a GSA schedule contract. Blanket purchase agreements are not contracts.

The government's basis for payments, contractor's obligations, and the party assuming more risk for cost overruns changes depending on whether the contract is fixed price, cost reimbursable, or time-and-materials.		
Fixed price	Cost reimbursable	Time-and-materials (focus of this report)
<b>Government</b> pays fixed price even if actual total cost of product or service falls short of or exceeds the contract price. May also pay an award or incentive fee related to performance.  <b>Contractor</b> provides an acceptable deliverable at the time, place, and price specified in the contract.  <b>Who assumes risk of cost overrun?</b> Contractor.	<b>Government</b> pays contractor's allowable costs. Also pays a fee, which may be related to performance.  <b>Contractor</b> makes good faith effort to meet government's needs within the estimated cost.  <b>Who assumes risk of cost overrun?</b> Government.	<b>Government</b> pays fixed per-hour labor rates that include wages, overhead, general administrative costs, and profit; government might reimburse contractor for other direct costs, such as travel and materials costs.  <b>Contractor</b> makes good faith effort to meet government's needs within the ceiling price.  <b>Who assumes risk of cost overrun?</b> Government.

Sources: FAR, Defense Federal Acquisition Regulation Supplement, DOD Contract Pricing Guide (data); GAO (presentation and analysis).

Time-and-materials contracts comprise the highest contract type risk to the government, according to the organizations who are responsible for promulgating federal acquisition regulations. Like cost-reimbursable contracts, they require that the contractor use its best efforts to provide

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the goods or services at the stated ceiling price.<sup>3</sup> If the contractor performs work pursuant to the contract, the contractor is entitled to be reimbursed for labor at agreed-upon rates, which include wages, overhead, general and administrative expenses, and profit; and for materials purchased at cost. If the services delivered do not meet contract requirements and the government exercises its right to have the contractor correct the deficiencies, the government pays the additional labor and material costs to do so, excluding the portion of the labor rate attributable to profit.<sup>4</sup>

Because of the risks involved, the Federal Acquisition Regulation (FAR) directs that time-and-materials contracts should only be used when it is not possible at the time of award to estimate accurately the extent or duration of the work or to anticipate costs with any reasonable degree of confidence.<sup>5</sup> The regulation also states that this type of contract may only be used after the contracting officer executes a written justification, known as a determination and findings, that no other contract type is suitable. Time-and-materials contracts also must include a ceiling price that the contractor exceeds at its own risk. In addition, because these contracts do not include a positive profit incentive for the contractor, appropriate government monitoring of contractor performance is required to give reasonable assurance that efficient methods and effective cost controls are being used. Documentation that the monitoring occurred is required by the FAR.<sup>6</sup>

The question of whether time-and-materials contracts could be used for commercial acquisitions has been an issue of some contention. During discussion of proposed provisions in the Services Acquisition Reform

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<sup>3</sup> We note that time-and-materials contracts also exhibit characteristics of fixed-price contracts. The labor rates in a time-and-materials contract are similar to a fixed-price contract in that these rates are fixed, regardless of the contractor's actual labor costs or indirect expenses. The contractor assumes the cost risk associated with these labor rates but can also maximize its profit by finding individuals who meet the qualifications of a labor category at the lowest possible cost.

<sup>4</sup> FAR Part 52.246-6(f), Inspection—Time-and-Material and Labor-Hour. Additional provisions in FAR Parts 52.246-6(g) and (h) describe alternate actions the government may take if the delivered services do not meet contract requirements.

<sup>5</sup> FAR Part 16.601(b)(1).

<sup>6</sup> FAR 52.246-6(b), Inspection—Time-and-Material and Labor-Hour and FAR 46.104, Contract Administration Office Responsibilities. The FAR uses the term “surveillance”; however, for clarity we use the term “monitoring” in this report.

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Act of 2003,<sup>7</sup> which explicitly authorized the use of time-and-materials contracts to purchase commercial services under certain circumstances, a former Administrator of the Office of Federal Procurement Policy noted that the issue of whether time-and-materials contracts should be authorized under the FAR's commercial acquisition procedures appeared to trigger more public dialogue than any other provision of the act. While some believed that increased use of time-and-materials contracts would encourage more commercial firms to compete for government business, others, such as the DOD Inspector General, opposed the idea of expanding use of this contract type for commercial item purchases. In fact, although the FAR explicitly prohibited agencies from purchasing commercial items or services using time-and-materials contracts until February 2007 when it implemented the act's provisions, government agencies were doing so under GSA schedule contracts. According to GSA officials, this practice was allowed based on the agency's interpretation of the Federal Acquisition Streamlining Act of 1994 (FASA)<sup>8</sup>, which required that fixed-price contracts be used to the "maximum extent practicable" for commercial acquisitions and remained silent on whether time-and-materials contracts were allowed. Viewing the FAR as more restrictive than FASA, in March 1998 GSA executed a FAR deviation to allow for the use of time-and-materials contracts for commercial services. But this deviation applied only to Information Technology Schedule 70, one of the many GSA schedules. GSA officials were unable to provide us with additional FAR deviations that allowed time-and-materials orders under the other GSA schedules, such as those with contracts for professional, administrative, and management services, despite our requests.

Commercial companies avoid time-and-materials contracts in most situations. In a prior review,<sup>9</sup> we surveyed 23 companies—22 of which used time-and-materials contracts in their commercial practices, either as a buyer or a seller. The companies represented 18 different industries. They reported using time-and-materials contracts when they could not complete a well-defined scope of work and when risk could be managed by monitoring costs and contractor performance. Company representatives told us they use this contract type in the early stages of

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<sup>7</sup> Services Acquisition Reform Act of 2003, Title XIV of National Defense Authorization Act for Fiscal Year 2004, Pub. L. No. 108-136 (Nov. 24, 2003).

<sup>8</sup> Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355 (Oct. 13, 1994).

<sup>9</sup> We presented a briefing entitled "Time and Materials Contracting: Survey of Private Sector Practices" to the Office of Federal Procurement Policy in January 2005.

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projects, in situations when work is not easily definable (such as emergency repairs) or is prone to change because of unforeseen conditions. One representative response from industry was that they use time-and-materials only when the risk and cost of the deal is low and/or they truly do not know what they want.

The Acquisition Advisory Panel, which the Services Acquisition Reform Act established to review acquisition laws and regulations regarding many different acquisition issues—including time-and-materials contracts—issued its draft report to the Office of Federal Procurement Policy and the Congress in December 2006. The panel expressed concern about risks associated with the time-and-materials contract type, particularly in the areas of price and contract management. The panel's Commercial Practices Working Group noted that commercial buyers who spoke to the panel provided many sound reasons not to use time-and-materials contracts, but when they do use this contract type, they “endeavor to maintain tight controls over the contracting process, costs, and levels of effort.” The panel made several recommendations regarding time-and-materials contracts, including (1) current policies limiting their use should be enforced; (2) whenever practicable, procedures should be established to convert work to a performance-based effort; and (3) the government should not award time-and-materials contracts unless the overall scope of the effort, including the objectives, has been sufficiently defined to allow for efficient practices and effective government oversight.

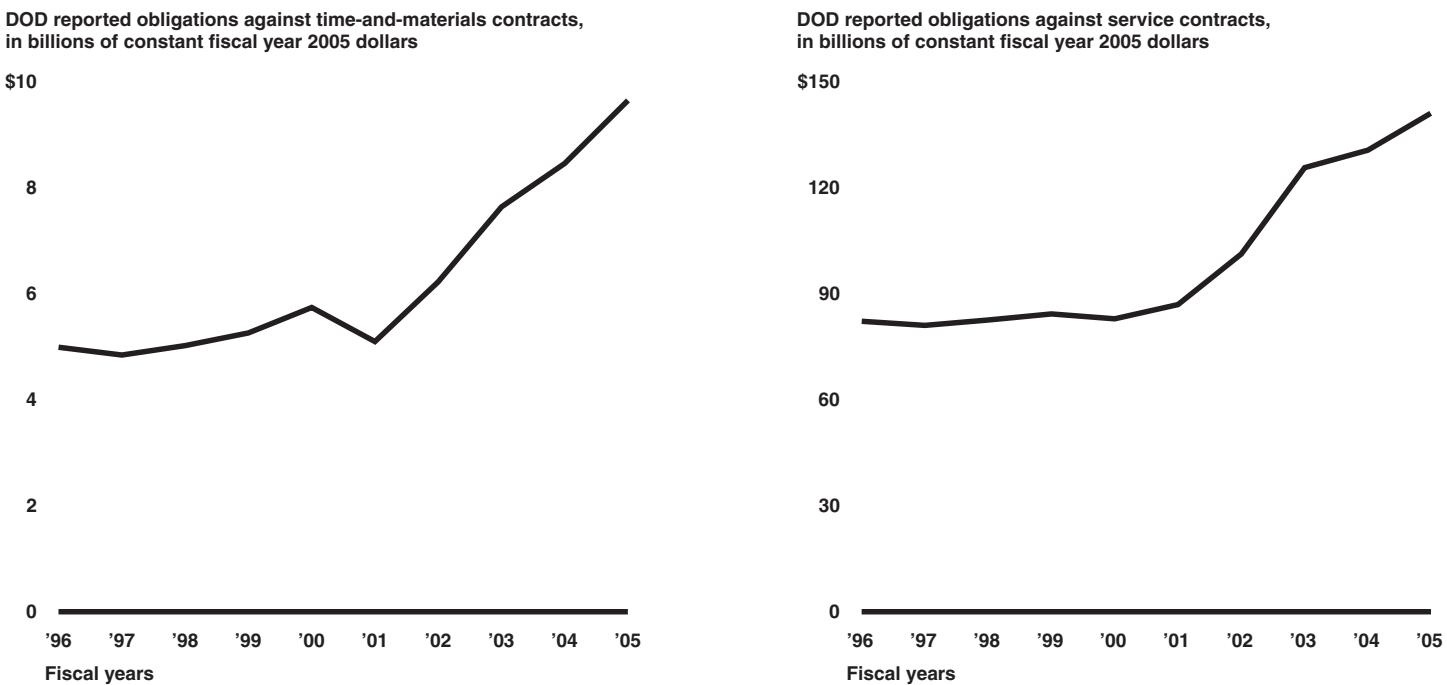
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## Overall Trend in Time-and-Materials Obligations Is Incomplete Because of Missing Data

From fiscal years 1996 through 2005, DOD's obligations against time-and-materials contracts rose from almost \$5 billion to over \$9.6 billion, according to DD350 data. This rate of increase was somewhat greater than the increase in DOD's overall service spending. Not shown in DD350 data, however, is DOD's spending through time-and-materials contracts for orders placed against GSA and other federal schedules. The data gap is the result of DOD instructions and procedures that directed users not to code contract type when the action was an order under a federal schedule. These instructions were in effect from fiscal year 1997 until fiscal year 2007. Reporting should improve starting in fiscal year 2007, with DOD's transition to the government's Federal Procurement Data System-Next Generation. In that system, a contract type is identified for all orders, including those under GSA schedule contracts.

Figure 2 illustrates the growth rate of DOD's reported time-and-materials obligations and the growth rate of DOD's overall service contract obligations.

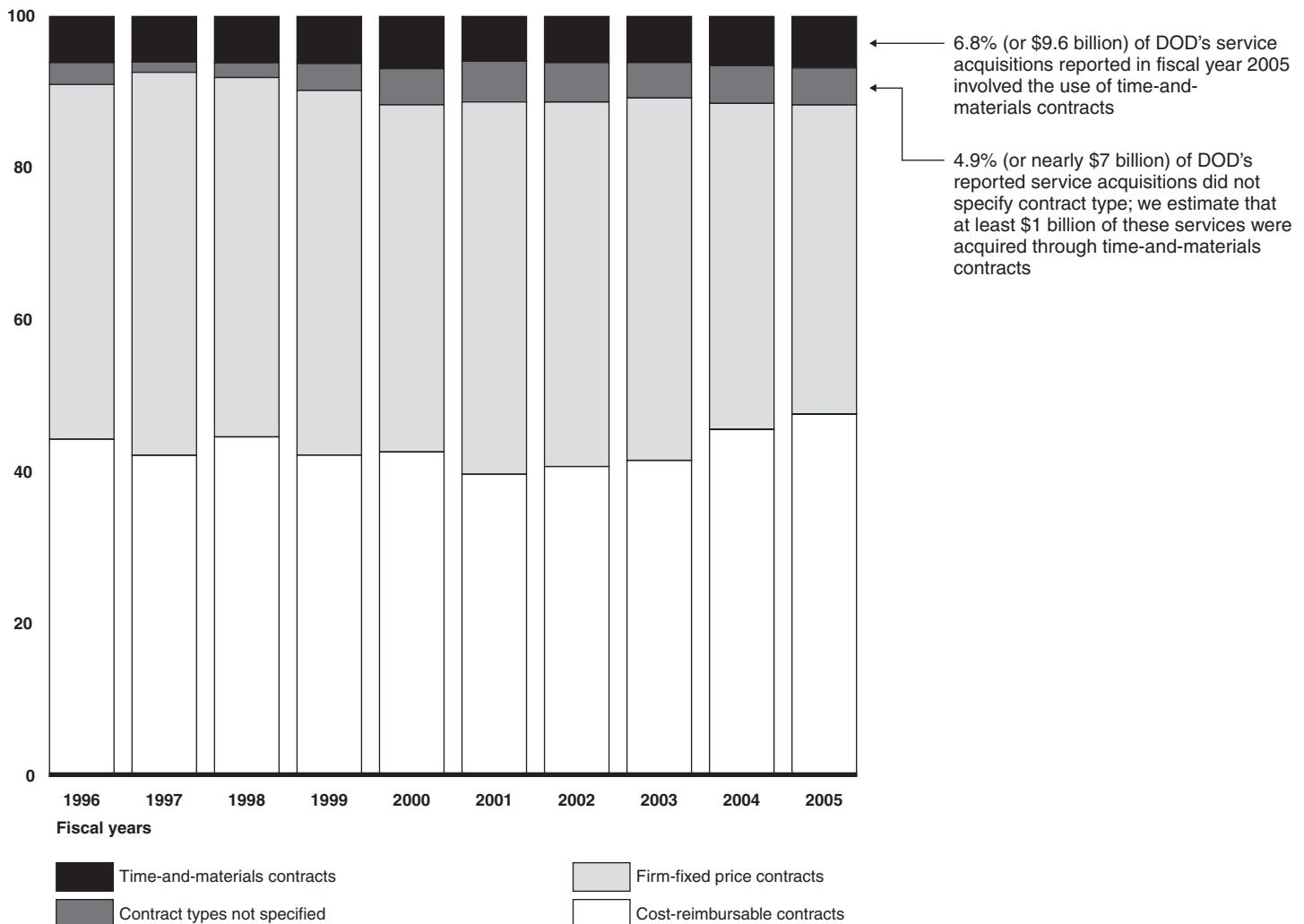
**Figure 2: DOD Reported Obligations against Service Contracts**



When comparing contract types, DOD's reported use of time-and-materials for service acquisitions has remained relatively steady over the past 10 years. Contracts reported as time-and materials ranged from 5.9 percent to 6.8 percent of service contract dollars. Figure 3 depicts the obligations coded as time-and-materials as well as those where contract type was not coded—i.e., schedule orders.

**Figure 3: Percentage of DOD Reported Obligations, Sorted by Contract Type, for Service Acquisitions, Fiscal Years 1996 through 2005**

DOD reported obligations, in percent, by contract type



Sources: DOD DD350 database (data); GAO (analysis and presentation).

As the use of GSA schedules has grown, so has the size of DOD's knowledge gap. Reported data on DOD's schedule orders for services show an increase of almost 200 percent over the past 10 years, from \$2.4 billion in fiscal year 1996 to \$6.9 billion in 2005. None of these entries include a contract type. To shed light on the potential magnitude of the missing data, we calculated the percentage of obligations with a reported contract type of time-and-materials for each of the 24 categories of

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services in the DD350 database. We then applied this same percentage, for each service category, to the dollars that were uncoded—i.e., schedule orders. For example, in fiscal year 2005, contract type was not coded for \$3.4 billion in obligations related to the acquisition of professional, administrative, and management support services. Of reported obligations in this service category for which DOD did record a contract type, almost 17 percent was obligated against time-and-materials contracts. We applied the 17 percent to the \$3.4 billion to estimate that \$570 million of obligations in this service category was likely to be time-and-materials. In looking at a single year, fiscal year 2005, our conservative estimate is that over \$1 billion of the \$6.9 billion in services acquired through federal schedules was obligated against time-and-materials contracts. For fiscal year 2005, this would represent an over 10 percent increase in the dollars attributed to time-and-materials contracts. Estimates from others place the amount higher. The GSA Inspector General in 2003 reported that use of time-and-materials was prevalent under schedule contracts and that 65 percent of the 1,976 task orders for professional services purchased by several agencies under the schedules it surveyed were priced on a time-and-materials basis.<sup>10</sup> In 2005, the GSA Assistant Inspector General for Auditing told the Acquisition Advisory Panel that recent studies of 523 GSA Federal Technology Service contract awards, valued at over \$5.4 billion, found over 60 percent of all orders were awarded on a time-and-materials basis.

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## Most of DOD's Time-and-Materials Obligations Are for Three Categories of Services

Over 75 percent of DOD's reported time-and-materials purchases are for professional, administrative, and management support services; information technology and communications; and maintenance, repair, and rebuilding of equipment. These are three of the largest and among the fastest growing categories of DOD service acquisitions. Obligations for professional, administrative, and management support services, for example, increased 161 percent from 1996 to 2005. Table 1 shows the percentage of DOD contract dollars spent using time-and-materials contracts for these three categories.

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<sup>10</sup> GSA Inspector General, *Audit of Procurement of Professional Services from the Federal Supply Service's Multiple Award Schedules*, Report Number A020243/F/A/V03009 (Arlington, Va.: July 31, 2003).

**Table 1: Categories of Services Acquired Most Using Time-and-Materials Contracts, Fiscal Year 2005**

Type of service	DOD obligations in fiscal year 2005	DOD obligations using time-and-materials contracts in fiscal year 2005	Time-and-materials obligations as a percentage of DOD's total fiscal year 2005 obligations
Professional, administrative, and management support services	\$28.3 billion	\$4.2 billion	15 percent
Information technology and communications	10.3 billion	1.8 billion	18 percent
Maintenance, repair, and rebuilding of equipment	11.4 billion	1.3 billion	12 percent

Sources: DOD DD350 database (data); GAO (presentation and analysis).

Note: Percentages may not calculate within table due to rounding.

Table 2 shows that DOD is most often making its time-and-materials purchases by issuing task orders under indefinite-delivery contracts, according to reported obligations.

**Table 2: Reported Time-and-Materials Obligations by Contract/Order Type for Service Acquisitions, Fiscal Year 2005**

Contract/order type	DOD obligations in fiscal year 2005	Percentage of obligations
Order under an indefinite-delivery contract	\$7.928	82
Definitive contract	0.832	9
Blanket purchase agreement order under federal schedule	0.761	8
Order under an agreement	0.066	less than 1
All other contracts	0.099	1

Sources: DOD DD350 database (data); GAO (analysis).

Notes: Reported information does not include orders placed off federal schedules (e.g., GSA schedule contracts). "All other contracts" include letter contracts, orders from Federal Prison Industries or the Javits-Wagner-O'Day Program for the blind or severely disabled, and awards under FAR Part 13 simplified acquisition procedures.

In addition to reported data in DOD's procurement information system, our analysis of contract files and discussions with DOD officials showed that the department is using time-and-materials contracts and orders to acquire contract services to supplement the government's workforce. For example, under one of the contracts we reviewed, the Defense Intelligence Agency (DIA) hired subject matter experts in the intelligence field for such things as assisting in the implementation of defense intelligence operational planning, including identifying requirements; establishing an

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in-theater contract management branch to oversee contractor personnel acquisitions, performance, and training; research and analysis in support of human intelligence collection operations; and serving as a security officer. According to a DIA official, contractor personnel were needed to backfill the government workforce in light of changing and increased operational requirements. Many of these contractor personnel were former DIA employees. In another case, the Air Force signed a 1-year contract to acquire advisory and assistance services<sup>11</sup>—specifically, 27 contract employees to provide systems engineering and technical assistance—to support the Air Force Deputy Chief of Staff for Warfighter Integration. During a pre-award review of the statement of work, the contracting specialist indicated that it was necessary to use the word “assist” to describe certain activities, such as acquisition strategy development, so that the statement of work did not show the contractor performing inherently governmental functions.

Government personnel are increasingly finding themselves working side-by-side with contractors, often performing similar roles. The Acquisition Advisory Panel, in its December 2006 draft report, found that, as the workforce increasingly reflects a “blend” of government and contractor personnel, issues have arisen with respect to the proper roles and relationships of federal employees and contractors. It pointed in particular to uncertainties about the scope and application of what are “inherently governmental” functions, the practical difficulties of enforcing the current FAR prohibition on personal services contracts,<sup>12</sup> and the increasing probability of, and need to protect against, organizational conflicts of interest. The report also noted that, with the growth of a workforce in which contractor employees are working alongside federal employees, performing identical functions, questions have been raised about whether the contractor employees should be required to comply with certain ethics

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<sup>11</sup> Advisory and assistance services include services provided under contract to support or improve such things as organizational policy development, decision making, or management and administration. It can also mean the furnishing of professional advice or assistance rendered to improve the effectiveness of federal management processes or procedures. All advisory and assistance services are classified in one of the following definitional subdivisions: management and professional support services; studies, analyses, and evaluations; or engineering and technical services. FAR 2.101.

<sup>12</sup> The key indicator of a personal services contract is whether the government exercises relatively continuous supervision and control over the contractor personnel performing the services. The FAR lists elements that may indicate whether a personal services contract exists. FAR 37.104.

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rules that apply to government personnel. It made a number of recommendations pertaining to these issues.

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## DOD Frequently Did Not Justify Why Time-and-Materials Contracts Needed but Used Them for Ease and Flexibility

DOD contracting and program officials frequently did not justify why time-and-materials contracts were the only contract type suitable for the procurement. The main reasons time-and-materials contracts are used, according to the officials we interviewed, are the speed with which contracts can be awarded and the flexibility they provide in adjusting labor hours or labor categories in light of changing priorities—often as a result of requirements that are not firm—or funding uncertainties. Existing management controls, such as contracting officers' written justifications and acquisition plans, could help decision makers to ensure that time-and-materials contracts are used only when appropriate. However, for most of the contracts we reviewed, the justifications did not include a rationale showing why no other contract type was suitable, nor did the acquisition plans. With a few exceptions, little attempt was made to convert follow-on contracts or task orders to a different contract type, even when historical data existed. Recent revisions to the FAR implement a number of stricter requirements for contracting officers to justify use of time-and-materials contracts, but most pertain only to commercial acquisitions.

## Lack of Firm Requirements, Funding Uncertainties, and Pressure to Award Contracts Drive Use of Time-and-Materials

Contracting and program officials told us that their decisions to use time-and-materials contracts were driven by the flexibility this contract type provides to deal with unknowns related to the acquisition—particularly a lack of firm requirements—and the ability to award these contracts quickly, not because this contract type was the only one suitable. The combination of indefinite-quantity contracts and time-and-materials allows contracting officers to get new work on contract quickly, because labor rates have been pre-negotiated. In fact, based on DD350 data, for the five largest contracts we examined—each with obligations of more than \$250 million through fiscal year 2005—that permitted various contract types,<sup>13</sup> time-and-materials was by far the predominant type used, as shown in table 3.

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<sup>13</sup> Contracts may include various contract types for different line items.

**Table 3: Contract Types Used for Largest Dollar Value Contracts in Our Sample**

Dollars in thousands	Fixed price	Cost reimbursable	Time-and-materials	Total
Contract 1	\$456	0	\$1,510,146	\$1,510,602
	0.03%	0	99.97%	100.00%
Contract 2	2,053	0	1,341,109	1,343,161
	0.15%	0	99.85%	100.00%
Contract 3	43,558	\$4,906	612,213	660,677
	6.59%	0.74%	92.66%	100.00%
Contract 4	118,539	3,494	200,360	322,393
	36.77%	1.08%	62.15%	100.00%
Contract 5	24,634	22,493	218,014	265,141
	9.29%	8.48%	82.23%	100.00%

Sources: DOD DD350 database (data); GAO (analysis).

Note: Totals may not add due to rounding.

Use of time-and-materials under indefinite-quantity contracts also allows contracting officers to keep adding work to the orders, since hours and funds are only limited by the ceiling price of the contract. For example:

- The original value of a Defense Information System Agency (DISA) task order for installation, de-installation, and maintenance services related to the Defense Information System Network was \$20.7 million for a 1-year period. The value of the order has grown to over \$386 million and has been in place for over 5 years. According to a DISA official, instead of issuing a new task order, the task order is “renewed” on a yearly basis.<sup>14</sup>
- The value of a 1-year task order under the Air Force’s Contractor Field Team contract for the maintenance of aircraft deployed to support Operation Iraqi Freedom increased from \$23.9 million to over \$221 million.

Contracting and program officials also noted that time-and-materials contracts provide DOD the flexibility to shift the skill sets being acquired by adjusting the distribution of hours between labor categories. However,

<sup>14</sup> According to a DISA official, DISA’s legal office concurs that it is administratively prohibitive to issue new task orders, in part due to foreign logistics requirements.

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this type of flexibility is only needed if DOD is unable to define its requirements in terms of outcomes. The need for improved requirements definition was also addressed by the Acquisition Advisory Panel in its December 2006 draft report. The panel found that the government fails to invest in the acquisition planning phase of procurement, focusing on rapid awards rather than on defining requirements. The testimony the panel heard was consistent in identifying the major contributors to this problem as the cultural and budgetary pressure to quickly award contracts or orders, combined with a lack of market expertise in an already-strained acquisition workforce.

The pressure to get to award was evident in several of the contracts we examined and contributed to the use of time-and-materials contracts over other contract types. According to the contracting officers, this pressure was the result of such factors as the need to get supplemental funding on contract, the expiration of an existing contract, or urgent customer demands. They told us they turned to time-and-materials contracts or orders in these situations because they require less up-front effort than cost-reimbursable contracts to determine that prices, in the form of labor rates, are fair and reasonable; require less specific requirements than are needed to support a fixed-price bid; or had been previously used. For example, the Air Force had been acquiring advisory and assistance services under a time-and-materials contract when it determined that the work was out of the contract's scope. It quickly put in place a new contract, again under a time-and-materials arrangement even though there was historical data available, because, according to an Air Force official, it was expedient and the customer was comfortable with this contract type.

According to contracting and program officials, budget pressures are also driving contracting officers to accept more risk by using time-and-materials contracts. Army officials told us that cost-reimbursable and time-and-materials contracts are being chosen over fixed-price contracts in part because of the way funding is allocated. They stated that funding is being allocated to Army programs and offices on a quarterly basis, based on shifting priorities. Without a stable funding stream with which to fully fund fixed-price contracts, contracting officers are looking to the flexibility provided by time-and-materials contracts, which allow them to take actions such as adjusting the number of hours being purchased. Similarly, Air Force officials told us that when the military service was directed to cut spending on contractor support services by 29 percent in 2006, it was easier and less costly to change or eliminate requirements on time-and-materials contracts than on fixed-price contracts.

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## Contracts and Orders Lacked Justifications or Rationale Showing Why Time-and-Materials Was Needed

When choosing to use time-and-materials contracts, the FAR requires contracting officers to provide a written justification, known as a determination and findings, that no other contract type is suitable for the acquisition.<sup>15</sup> The determination and findings is required to set forth enough facts and circumstances to clearly and convincingly justify the determination made.<sup>16</sup> Contract type is also addressed in acquisition plans, which set forth the overall strategy for managing the acquisition.<sup>17</sup> These management controls are designed to help decision makers ensure that a time-and-materials contract is appropriate.<sup>18</sup> In most cases, however, the justifications and plans we examined did not include a rationale showing why less risky contract types could not be used for the procurement. The GSA and DOD Inspectors General have also reported on a lack of determinations and findings and contract files with minimal information to support the use of time-and-materials contracts.<sup>19</sup>

We found that some contracting officers' justifications for use of time-and-materials contracts quoted language from the FAR<sup>20</sup>—such as stating that it was not possible at the time of awarding the contract to estimate

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<sup>15</sup> FAR 16.601(d)(1) and 1.701. Under the FAR, “contract” is defined to include all types of commitments that obligate the government to an expenditure of appropriated funds and that, except as otherwise authorized, are in writing. In addition to bilateral instruments, contracts include (but are not limited to) awards and notices of awards; job orders or task letters issued under basic ordering agreements; letter contracts; orders, such as purchase orders, under which the contract becomes effective by written acceptance or performance; and bilateral contract modifications. FAR 2.101.

<sup>16</sup> FAR 1.704.

<sup>17</sup> FAR 7.102 and 7.105(b)(4).

<sup>18</sup> An October 2, 2006, DOD policy implementing Section 812 of the National Defense Authorization Act for Fiscal Year 2006 requires senior DOD officials or their designees to review and approve the acquisitions of services valued at \$250 million or above for non-information technology service acquisitions and \$500 million and above for information technology services. This review should consider the anticipated pricing arrangement. We recently reported on DOD's review structure in the context of the department's overall management of its service acquisitions. See GAO, *Defense Acquisitions: Tailored Approach Needed to Improve Service Acquisition Outcomes*, GAO-07-20 (Washington, D.C.: Nov. 9, 2006).

<sup>19</sup> GSA Inspector General, *Compendium of Audits of the Federal Technology Service Regional Client Support Centers* (Washington, D.C.: December 2004); and DOD Inspector General, *Contracts for Professional, Administrative, and Management Support Services*, D-2004-015 (Arlington, Va.: October 2003).

<sup>20</sup> FAR 16.601.

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accurately the extent or duration of the work or to anticipate costs with any reasonable degree of confidence and that time-and-materials was the only suitable contract type—and did not set forth the rationale for why other contract types could not be used. In several of these cases, the determinations and findings did not include specifics related to the acquisition at hand.

We also found two indefinite-quantity contracts, both of which allowed for only time-and-materials orders, that completely lacked written determinations and findings justifying the use of time-and-materials. One was a Navy contract for ongoing support related to F/A-18s sold through the foreign military sales program, and the other was a Navy contract for technical and engineering services regarding the maintenance of aging aircraft. The contracting officers said they were unaware of the FAR requirement to prepare a determination and findings.<sup>21</sup>

As shown above in table 3, the vast majority of DOD’s reported time-and-materials obligations are against orders under indefinite-quantity contracts. At the time of our review, the FAR did not require determinations and findings for task orders issued under indefinite-quantity contracts. Consequently, many of the time-and-materials orders we reviewed—even those issued under contracts that allowed for multiple order types—did not have a determination and findings showing why no contract type other than time-and-materials was suitable. On some of the contracts we reviewed, the contracting officers relied on the initial determination and findings for the indefinite-quantity contract to justify subsequent time-and-materials orders, even when the scope of work allowed under the contract was very broad. For example, the Army’s Communications-Electronics Command prepared a class determination and findings for the use of time-and-materials under a contract for equipment and engineering services. The document noted that the statement of work included many tasks, including research and development, systems integration and engineering, test and evaluation, studies, logistics support, training, and acquisition support. It stated that “Due to the complexity and variety of tasks available to Federal

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<sup>21</sup> The FAR specifically required a determination and findings for time-and-materials contracts, but was not explicit with respect to indefinite-quantity contracts. The FAR was recently amended for commercial acquisitions to require a determination and findings for indefinite-quantity contracts that only provide for the issuance of time-and-materials orders.

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customers, it is impossible to estimate the duration of work or to anticipate costs with any reasonable degree of certainty.”

We also found cases where ordering guides for specific contracts required a determination and findings before time-and-materials orders were used; in some of these cases, the contracting officers had not complied with the requirement.

- The Army placed an order for network and systems engineering services under a National Institutes of Health (NIH) governmentwide acquisition contract. The Army contracting officer did not complete a determination and findings for the order, stating that this was the responsibility of the NIH contracting officer. The NIH contracting officer told us that executing a determination and findings is normally the responsibility of the ordering agency. According to NIH’s ordering guide for this governmentwide acquisition contract, in the event that a time-and-materials order was contemplated, the customer (in this case, the Army) was required to follow the FAR requirements for completing a determination and findings.
- The DISA ordering guide for one of the indefinite-quantity contracts in our sample stated that a time-and-materials contract could only be used after the contracting officer executed a determination and findings that no other contract type was suitable. Such a determination had not been made for all three time-and-materials orders we reviewed under the contract.

Finally, we found two cases where agencies had issued time-and-materials orders under blanket purchase agreements based on GSA schedule contracts, but had not prepared determinations. GSA’s schedule ordering guidance, under “frequently asked questions” on the agency’s Web site, states that time-and-materials orders under schedule contracts require a determination that it was not possible at the time of placing the order to estimate accurately the extent or duration of the work or to anticipate cost with any reasonable degree of confidence. According to a GSA official, this guidance was posted in March 2005. Of the nine orders discussed below, six were issued prior to this guidance; however, three were issued after it was posted.

- DIA awarded two blanket purchase agreements against GSA schedule contracts, one for three orders totaling \$1.6 million for administrative operational support in the intelligence area and the other for three orders totaling \$23 million for information technology engineering and intelligence support. A determination

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had not been prepared for any of the orders.

- The Defense Contract Management Agency (DCMA) issued a blanket purchase agreement and three subsequent task orders under a GSA schedule contract for information technology services. The contract files did not contain a determination justifying the use of the time-and-materials orders. For one order, the price negotiation memorandum stated that the decision to use a time-and-materials contract was driven by the customer (i.e., program officials). The document did not discuss the customer's rationale for why no other contract type was suitable.

Acquisition officials at DCMA and DIA respectively attributed the lack of documentation to an understaffed acquisition workforce and inadequate agency acquisition policies.

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### Little Attempt to Change Contract Type for Follow-on Efforts

One way to decrease the risks inherent in time-and-materials contracts is to convert to a less risky contract type for follow-on efforts. In fact, a September 2004, Defense Procurement and Acquisition Policy memorandum directed that, when preparing the requirements for a follow-on contract to an existing time-and-materials or cost-reimbursable service contract, program officials should work with the contracting officer to determine if any portion can be broken out and ordered on a fixed-price basis.<sup>22</sup> The memorandum notes that the experience gained on the prior contract may serve as a basis to reasonably price similar future efforts on a fixed-price basis. The FAR, too, states that

In the course of an acquisition program, a series of contracts, or a single long-term contract, changing circumstances may make a different contract type appropriate in later periods than that used at the outset. In particular, contracting officers should avoid protracted use of a cost-reimbursement or time-and-materials contract after experience provides a basis for firmer pricing.<sup>23</sup>

We found little evidence, however, that efforts are being made to convert time-and-materials to fixed-price for follow-on efforts or recurring services, even when historical information existed. Examples follow.

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<sup>22</sup> The memorandum did not specifically reference orders; however, we note that DOD is obligating most of its time-and-materials dollars under orders.

<sup>23</sup> FAR 16.103(c).

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- The Army has continued to use a time-and-materials order under a GSA governmentwide acquisition contract to acquire information technology services to support an online educational contest for middle school students in the areas of science, math, and technology. According to the acquisition plan, the original directive for the program was neither detailed nor specific. The effort has now been ongoing for 4 years and is still priced on a time-and-materials basis.
  - In 1998, the Air Force signed a 10-year contract for B-52 engineering services that was a sole-source follow-on to a previously issued time-and-materials contract. Overall, the contractor had been providing similar support for the B-52 program since 1963. During the development of the acquisition strategy, the Assistant Secretary of the Air Force for Acquisition initially rejected the program's plan to award a time-and-materials contract for this effort, advocating a cost-plus award fee contract instead. Eventually it was agreed that the time-and-materials portion of the work would be limited to 50 percent. For the first year, under monitoring by Air Force headquarters, this target was met. In fiscal year 2000, the percentage of time-and-materials obligations was 59 percent before decreasing back to 49 percent in fiscal year 2001. However, the level of monitoring slackened after 2001, and for 2006, nearly all of the work was on a time-and-materials basis.
  - In 2005, DISA issued a request for proposal for Encore II, a follow-on to its Encore I indefinite-quantity contract. Encore I offered a variety of information technology services to organizations throughout DOD and other federal agencies.<sup>24</sup> Although orders can be issued using various contract types, the contracting officer told us that most of the orders issued have been time-and-materials. The DOD Inspector General found that Encore II also allows for a significant portion of time-and-materials task orders and raised concerns about contractors not being motivated to increase efficiency and maximize performance. In response, DISA plans to implement goals to decrease the time-and-materials orders over the life of the contract. However, the Inspector General noted that these goals are based on a percentage of total dollars awarded in a calendar year. Therefore, DISA will not be able to determine whether it is meeting the established goal until the end of the year.

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<sup>24</sup> Encore I was a follow-on to DISA's Defense Enterprise Integration Services I and II multiple-award, indefinite-quantity information technology contracts.

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We found one case in which the Navy specified that a contract for aircraft structural inspections and repairs could be changed from time-and-materials to fixed price once sufficient knowledge about costs was attained. Under this contract, the Navy agreed that the contractor would perform structural inspection and repairs on one aircraft and use the data it collected, along with the cost history for similar efforts, to better define the extent, costs, and duration of the work so that the remaining work could be completed on a fixed-price basis. As it turned out, the Navy was able to use the data from the previous effort to convert all service and repair work to fixed price shortly after the contract was signed.

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### New Rules Implementing Provisions in Services Acquisition Reform Act Strengthen Justifications for Time-and-Materials Contracts for Commercial Acquisitions

On December 12, 2006, the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (the Councils) agreed on a final rule amending the FAR to implement section 1432 of the Services Acquisition Reform Act of 2003.<sup>25</sup> The act authorized the use of time-and-materials contracts for the following categories of commercial services: (1) commercial services procured for support of a commercial item<sup>26</sup> and (2) any other category of commercial services that is designated by the Administrator of the Office of Federal Procurement Policy on the basis that

- the commercial services in such category are of a type of commercial services that are commonly sold to the general public through use of time-and-materials contracts and
- it would be in the best interests of the federal government to authorize use of time-and-materials contracts for purchase of the commercial services in such category.

The final rule includes a number of stricter requirements for contracting officers that directly address many of the problems we found with the use of time-and-materials contracts. For example, contracting officers' written justifications must describe actions planned to maximize the use of fixed-price contracts on future acquisitions for the same requirements, and they must be prepared for task orders. However, most of the revisions pertain to commercial acquisitions only. In responding to public comments on the proposed regulations, the Councils acknowledged that the rule contained more requirements for commercial determinations and findings than for

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<sup>25</sup>The changes went into effect in February 2007.

<sup>26</sup>As described in 41 U.S.C. 403(12)(E).

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non-commercial. Their rationale was that the additional requirements were needed to encourage the preference for fixed-price contracts for commercial items. At the same time, though, the Councils stated that they believe additional controls are needed to ensure both commercial and non-commercial time-and-materials contracts are only used when no other contract type is suitable. The DOD Acquisition Regulations Council chair at the time this FAR rule was being considered told us that discussions focused mostly on commercial acquisitions because the belief was that this was the area where tighter controls were needed. We note that none of the 28 time-and-materials contracts, agreements, and orders we selected for review were coded as commercial acquisitions in DOD's procurement information system.<sup>27</sup>

The new provisions pertaining to commercial acquisitions of services on a time-and-materials basis include the following:

- The determinations and findings must at a minimum (1) describe market research conducted; (2) establish that it is not possible at the time of placing the contract or order to accurately estimate the extent or duration of work or to anticipate costs with any reasonable degree of certainty; (3) establish that the requirement has been structured to maximize the use of fixed-price contracts on future acquisitions for the same or similar requirements (e.g., by limiting the value or length of the time-and-materials contract or order or establishing fixed prices for portions of the requirement); and (4) describe actions planned to maximize the use of fixed-price contracts on future acquisitions for the same requirements.
- Indefinite-delivery contracts must be structured to the maximum extent practicable to allow the use of fixed-price orders. For these contracts, each time-and-materials order under an indefinite-delivery contract must have a separate determination and findings.
- If an indefinite-delivery contract only allows for time-and-materials orders, a determination and findings shall be executed to support the basic contract and shall also explain why providing for a fixed-price alternative is not practicable. Further, the determination and findings must be approved one level above the contracting officer.

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<sup>27</sup> The DD350 data for three non-DOD contracts in our review did not indicate whether or not they were commercial.

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One new provision applies to all time-and-materials acquisitions—commercial and non-commercial. It requires the determinations and findings to be signed before the execution of the base period and any option periods. If the period of performance exceeds 3 years, the determination and findings must be approved by the head of the contracting activity. According to the Councils, this provision is also intended to help avoid protracted use of non-commercial time-and-materials contracts after experience provides a basis for firmer pricing.

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## Contractor Performance Monitoring Often Did Not Reflect Inherent Risks of Time-and-Materials Contract Type

The FAR calls out the need for appropriate government oversight on time-and-materials contracts to give reasonable assurance that efficient methods and effective cost controls are being used, because this contract type provides no incentive for the contractor to control costs or be efficient. In addition, DOD guidance requires adequate monitoring of contractor performance. This monitoring is to be properly documented, including a plan setting forth the required activities and, if applicable, specific performance measures. For time-and-materials contracts, the plans could include activities such as ensuring that the labor categories and rates in the contract match those provided by the contractor. Monitoring of performance is typically performed by a contracting officer's representative (COR), who is designated as such by the contracting officer.<sup>28</sup> Duties associated with the monitoring include reviewing contractor costs to determine if there are variances from the budgeted or anticipated costs, such as by labor category. The COR is also responsible for assuring that the contract performance is consistent with the description and scope of the contract.<sup>29</sup>

Although we found that CORs were assigned in most cases, many of the contract files we reviewed did not include plans setting forth how the monitoring was to be accomplished, and we found wide discrepancies in

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<sup>28</sup> CORs are typically responsible for such things as verifying that the contractor performs the technical requirements of the contract in accordance with contract terms, monitoring the contractor's performance, notifying the contractor of deficiencies, and directing appropriate action to effect correction. They are not authorized to modify the contract terms or conditions or to obligate the payment of any money by the government.

<sup>29</sup> According to Defense Procurement and Acquisition Policy and DCAA officials, oversight of contractor payment requests on time-and-materials contracts is conducted by DCAA. The officials noted that CORs are not responsible for certifying costs or performing cost verifications, such as reconciling contractor labor cost records or material cost invoices to amounts included on public vouchers.

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the rigor with which monitoring was performed. For example, on the Army's \$17 million Omnibus 2000 logistics support services contract, CORs told us that no monitoring plans or records were required and that they did not review invoices.<sup>30</sup> Further, some CORs had a limited background in acquisition issues or were new to the role. A DIA COR, who was accustomed to working on contracts for goods and supplies, not services, told us the COR training received was not adequate and, as a result, it took some time to learn how to do the job. An Army customer on an Air Force maintenance contract hired a contractor to perform day-to-day monitoring. The official stated that between promotions and a lack of experience, the Army lacked in-house government capability to provide adequate oversight. In general, on the contracts we reviewed, CORs performed their monitoring role based on information in monthly progress reports from the contractor that provided a status of ongoing work and information on how fast money was being spent, known as "burn rates."

On the other hand, we found a case in which DOD generated regular reports of contractor performance, based on a documented monitoring plan. An Air Force contract to meet surge requirements for field maintenance used a management plan that outlined monitoring responsibilities for contracting staff, required formal delegation of these responsibilities, and provided a standard government form for monthly reporting on all task orders. We also found a number of cases in which contracting officers obtained timesheets and other supporting documentation along with billing submissions. Doing so meant the program managers had the necessary information to closely monitor contractor performance using labor hours according to specific labor categories. On one DIA task order, the program manager used the information from invoices to monitor the charges in program management labor categories for the contractor. The program manager stated that if these costs exceeded 5 percent of the value of the hours billed during the period, the contractor would be questioned about the reasons for those charges.

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<sup>30</sup> Some of the contracting officials said that monitoring under the follow-on contract is more substantial.

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## DOD Is Paying More Than Actual Costs for Subcontracted Labor on Some Contracts

We found that contracts specified various ways prime contractors can be reimbursed for subcontracted labor. Some required the prime contractor to be reimbursed for the actual costs it paid for the subcontracted labor, others set forth separate rates for subcontractors, some contained “blended” prime and subcontract rates, and some permitted the prime contractor to be reimbursed for subcontracted labor at the prime’s own rates. The last category in particular has caused some concern within DOD. For example, DCAA audit reports have questioned costs under this billing arrangement, claiming the differential to be additional profit to the prime contractor. On the contracts we reviewed that allowed the prime contractor to bill DOD for subcontractor labor using its own prime rates,<sup>31</sup> we found a wide range of differences between prime contract and subcontract labor rates. New FAR provisions and a Defense Federal Acquisition Regulation Supplement (DFARS) interim rule set forth different rules about how prime contractors are to be reimbursed for subcontracted labor under competitive versus non-competitive, and commercial versus non-commercial, procurements.

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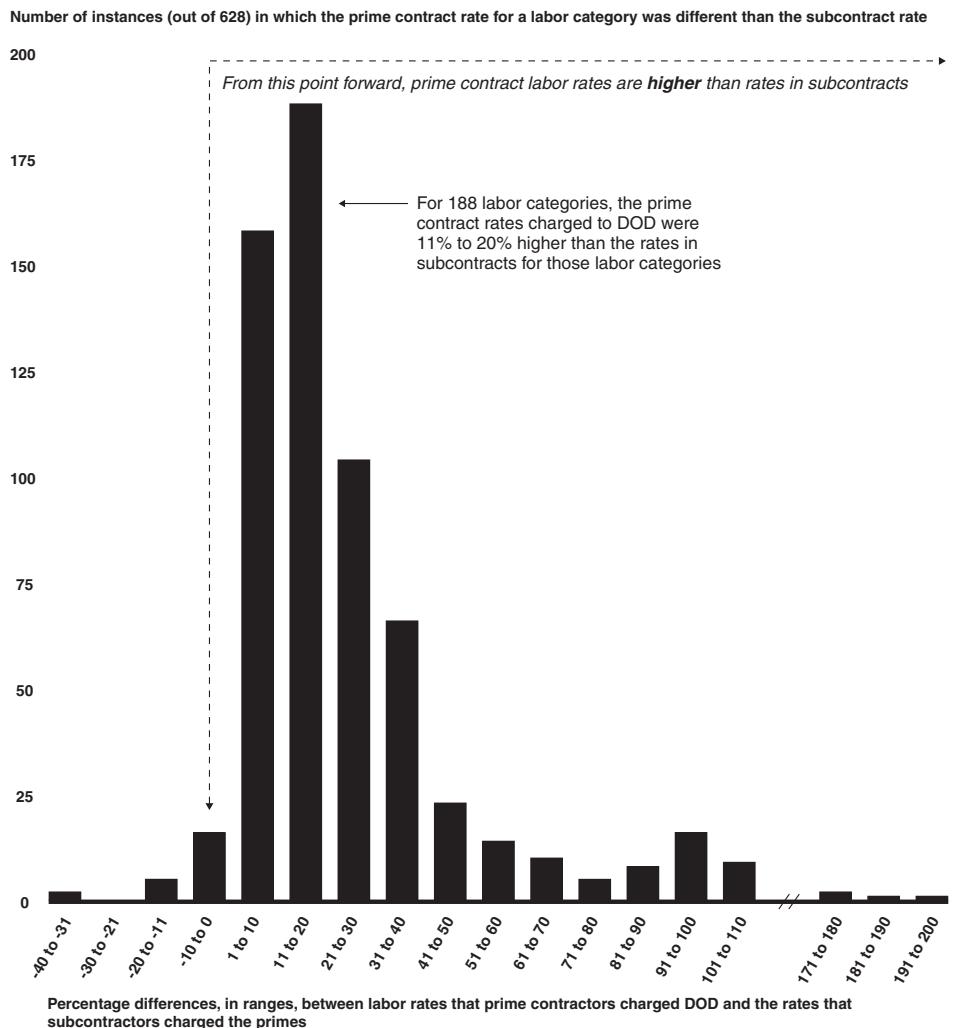
<sup>31</sup> Among the 28 time-and-materials contracts, agreements, and orders that we examined in depth, we reviewed one blanket purchase agreement that demonstrated this billing practice. We collected information on the difference between the prime and subcontract labor rates under this agreement. Subsequently, we identified an additional 12 contracts and agreements that allowed the prime contractor to bill the government for subcontract labor using the prime contract labor rates.

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## **Prime Contract Labor Rates Were Usually Higher Than Subcontract Rates on Contracts We Reviewed**

We analyzed the differential between 628 prime and subcontract labor rates within 13 contracts or agreements we reviewed that allowed the prime contractor to bill DOD for subcontracted labor using prime contract rates. The differential ranged from negative 40 percent to 192 percent, with most falling in the 6 to 53 percent range. Figure 4 shows these differences under the 628 different labor rates. Each rate is associated with a labor category (e.g., program manager, systems engineer, or senior analyst) that includes a description of the position, along with minimum education and experience requirements.

**Figure 4: Percentage Differences between Prime Contract and Subcontract Labor Rates for 628 Labor Categories on 13 Contracts or Agreements**



Sources: Prime contracts, proposals, and subcontracts (data); GAO (analysis and presentation).  
Note: The figure reflects a break in percentage ranges between 111% and 170% because there were no instances of rate differentials within these ranges.

In most of these cases, the prime contract's labor rates were higher than the rates in subcontracts; therefore, the prime contractor could realize additional profit by using these subcontractors. One contractor representative told us that the rate differential for his company, which ranged from 2 to 14 percent, consisted of overhead, material handling costs, and subcontract administration costs, as well as profit. In another case, a contractor representative told us that the labor rate in the prime

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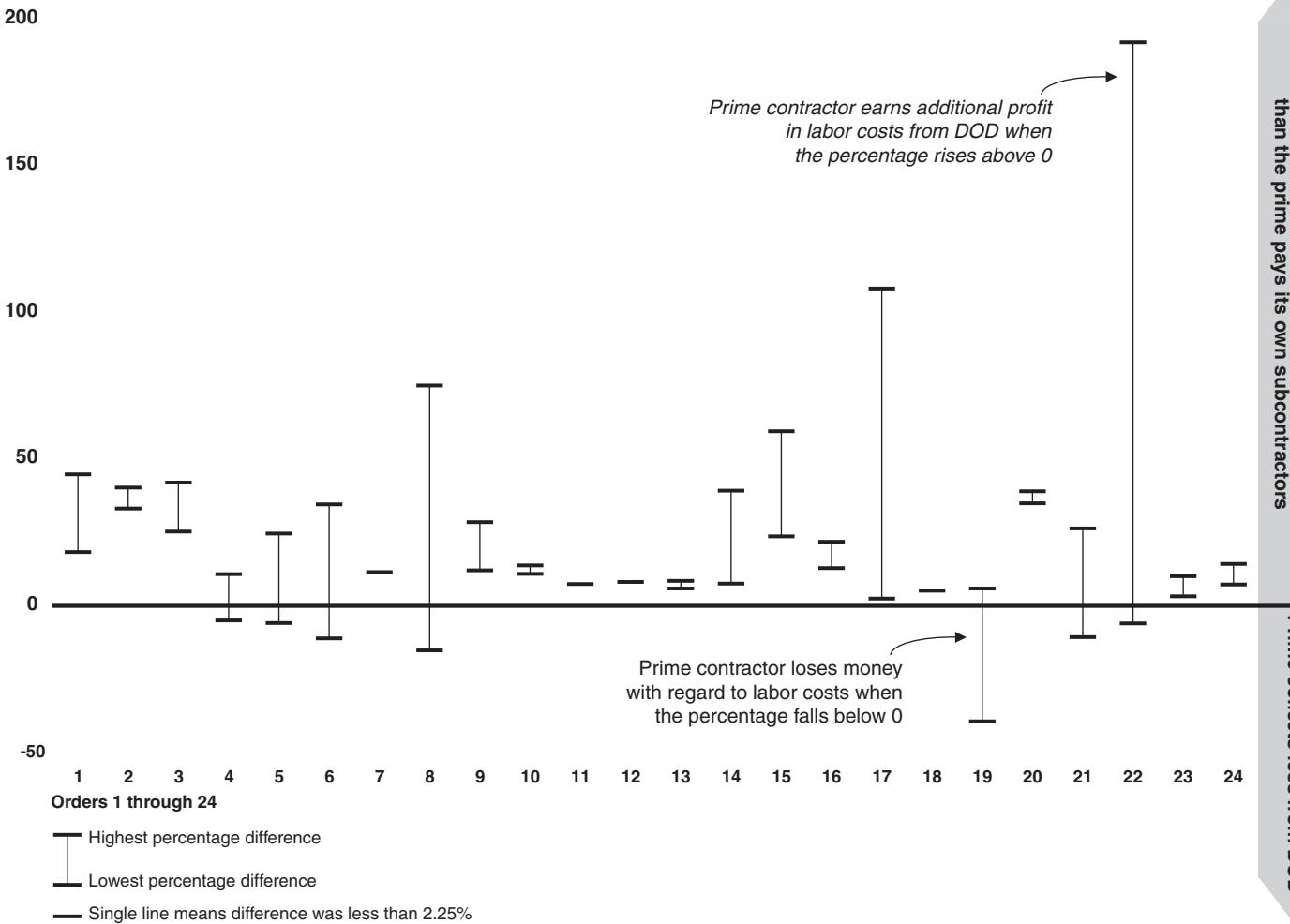
contract for a systems engineer was 108 percent more than the subcontract rate because the subcontractor provides temporary labor with a lower benefits package.

The prime contract's labor rates did not exceed the subcontract rate in all instances. In limited circumstances, we found that the subcontract rate for a given labor category was lower than the rate in the prime contract. For example, under one task order, the prime contractor was billing the government 38 to 40 percent less for one labor category than it was paying its subcontractors. In this instance, subcontract labor hours represented less than 6 percent of total labor hours associated with the task order. Most of the contractor representatives told us that the subcontract rates were established by negotiating with the subcontractors or after accepting bids. However, one representative told us that some larger subcontractors are unwilling to accept lower labor rates.

Of the 13 contracts and agreements we reviewed, all allowed task orders to be issued under them. In total, we reviewed 24 task orders associated with these contracts and agreements. While prime contract labor rates were almost always higher than subcontract rates, the magnitude of this difference varied, even within the same task order. Figure 5 shows the range of labor rate differentials within each of the 24 orders we reviewed.

**Figure 5: Range of Percentage Differences between Prime Contract and Subcontract Labor Rates for 628 Labor Categories in 24 Orders**

Percentage range, from highest to lowest



Sources: Prime contracts, proposals, and subcontracts (data); GAO (analysis and presentation).

Note: The range for each order is shown as a solid line, but is made up of multiple observations. So even though 7 of the 24 orders show instances in which the prime contract rate was less than the subcontract rate, these instances are still rare among the 628 labor categories for which we collected this information.

In some cases, the subcontract rates showed wide differences when compared to the prime contract rate, even within the same labor category. Table 4 provides examples of variations within and among labor categories.

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**Table 4: Selected Examples of Differences in Labor Rates between Prime Contracts and Subcontracts**

Contract	Labor category	Rate difference	Percent difference
A	Senior Analyst (Subcontractor 1)	\$11.23	16.48
	Senior Analyst (Subcontractor 2)	-10.43	-11.61
	Senior Analyst (Subcontractor 3)	12.73	19.10
B	Technician	-7.92	-15.70
	Technical Editor	19.34	75.19
	Engineer/Analyst	10.17	20.16
C	Program Manager Level 4	16.16	14.70
	Systems Engineer Level 4	5.39	6.30
	Systems Engineer Level 3	1.11	1.59
	Systems Engineer Level 2 (Subcontractor 1)	2.55	4.41
	Systems Engineer Level 2 (Subcontractor 2)	31.39	108.24

Sources: Contractors and DOD (data); GAO (analysis).

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**Defense Contract Audit Agency Identified Additional Profits Related to Subcontracted Labor**

At our request, DCAA queried its field offices to identify reports on questioned costs pertaining to the subcontractor billing issue. The query generated 11 audit reports that questioned over \$4 million in billings based on the rates subcontractors billed to prime contractors under DOD contracts.<sup>32</sup> The audit reports, issued between December 2004 and November 2006, contain varying levels of detail and reflect audits of incurred costs, final vouchers, and customer requested evaluations of billed amounts. They cover five different prime contractors. The audit agency, in accordance with the FAR payments clause for time-and-materials contracts<sup>33</sup> in effect at that time, considers as unallowable costs the amount that the prime contractor bills DOD in excess of the amount the subcontractor bills the prime contractor. In one case, DCAA found that a prime contractor realized profits ranging from 20 to 95 percent based on differences between billed amounts and the actual costs of subcontract labor.

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<sup>32</sup> DCAA provided two additional audit assignments that raised the issue of prime contractor billing for subcontracted labor without specifically questioning costs. According to DCAA, one audit is in process and the questioned costs will be reported when the report is issued. The second assignment was cancelled at the customer's request.

<sup>33</sup> FAR 52.232-7(b)(4).

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## Debate Has Surrounded How Primes Should Be Reimbursed for Subcontracted Labor, but New Regulations Enumerate Acceptable Billing Practices

The issue of how the government should reimburse prime contractors for subcontracted labor has been a matter of debate. For example, as noted above, DCAA has questioned contractors' proposed costs or billings for subcontracted labor at amounts other than the actual costs when the standard time-and-materials payments clause was included in the contract. In instances in which the contract specifically permitted the prime to bill for subcontracted labor at the prime contract rates, DCAA did not question those costs. In its official comments on proposed FAR cases pertaining to time-and-materials contracts,<sup>34</sup> DCAA stated that such a practice places the government at a greater risk of paying costs higher than what prime contractors actually pay without receiving any additional benefits. DCAA noted that this practice will incentivize prime contractors to maximize profits by subcontracting out more work and that the government will have to expend additional resources to monitor the quality and efficiency of the subcontracted labor to ensure that it is receiving the level of service for which it had contracted. DCAA has held that, if the FAR payments clause is in the contract, it applies. Until recently, the payments clause stated that

the Government will limit reimbursable costs in connection with subcontracts to the amounts paid for supplies and services purchased directly for the contract when the Contractor has made or will make payments determined due of cash, checks, or other forms of payment to the subcontractor....<sup>35</sup>

GSA has taken the position that prime contractors should bill for subcontracted labor at their own prime GSA schedule rates, posting this instruction on the agency's Web site. Industry associations have argued that only reimbursing the prime contractors for the actual costs of subcontracted labor (without profit) fails to recognize the risk that prime contractors assume when they subcontract. These associations have also indicated that requiring separate subcontract rates would be administratively burdensome for the government and the contractor and limit the ability to quickly bring on subcontractors.

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<sup>34</sup> FAR Cases 2004-015 "Payments under Time-and-Materials and Labor-Hour Contracts" (70 Fed. Reg. 56,314 (Sept. 26, 2005)) and 2003-027 "Additional Contract Types" (70 Fed. Reg. 56,318 (Sept. 26, 2005)). These FAR cases resulted in FAR amendments effective February 12, 2007 (71 Fed. Reg. 74,656 (Dec. 12, 2006) and 71 Fed. Reg. 74,667 (Dec. 12, 2006)), respectively.

<sup>35</sup> FAR 52.232-7 (3)(B)(4)(ii).

Effective February 12, 2007, FAR provisions clarified under what circumstances prime contractors can bill the government for subcontractor labor at the prime contract's labor rates. This billing practice is permitted now if the time-and-materials contract or order was competitively awarded or for a commercial service, but separate prime and subcontract rates are required if the contract was not competitively awarded.<sup>36</sup> An interim rule to DOD's supplement to the FAR is stricter, requiring prime contractors to charge at separate prime and subcontractor rates for all non-commercial, competitively-awarded contracts as well.<sup>37</sup> Table 5 summarizes the new FAR rule<sup>38</sup> and DOD's interim rule.

**Table 5: Governmentwide Provisions and Those in DOD's Interim Rule Regarding Billing for Subcontracted Labor under Time-and-Materials Contracts**

Commercial contracts (governmentwide)	Noncommercial contracts		
	Noncompetitive award		Competitive award
	Governmentwide	Non-DOD	DOD interim rule
Prime contractor is <u>not</u> required to propose separate rates for prime and subcontractor labor <sup>a</sup>	Prime contractor <u>is</u> required to propose separate rates for prime and subcontractor labor.	Prime contractor is <u>not</u> required to propose separate rates for prime and subcontractor labor <sup>b</sup>	Prime contractor <u>is</u> required to propose separate rates for prime and subcontractor labor.

Sources: FAR and Federal Register (data); GAO (presentation and analysis).

Note: Orders issued under GSA schedule contracts or associated blanket purchase agreements will fall into the commercial category.

<sup>a</sup>However, the prime contractor must specify whether the fixed hourly rate for each labor category applies to labor performed by the prime and/or subcontractors.

<sup>b</sup>However, for each category of labor, the prime contractor must establish fixed hourly rates using one of three options: separate rates for prime and subcontracted labor, blended rates, or a combination of separate and blended; and the prime must specify whether the fixed hourly rate for each labor category applies to labor performed by the prime and/or subcontractors.

Prior to these changes, we found that the Defense Finance and Accounting Service (DFAS) had acted proactively to limit the rate at which prime contractors bill for subcontracted labor. On one blanket purchase agreement under a GSA schedule contract, DFAS officials were concerned

<sup>36</sup> 71 Fed. Reg. 74,656 (Dec. 12, 2006) and 71 Fed. Reg. 74,667 (Dec. 12, 2006). The revised FAR payments clause for time-and-materials contracts conditions payment on hourly rates that meet the labor qualifications as specified in the contract (FAR 52.212-4 and 52.232-7).

<sup>37</sup> 71 Fed. Reg. 74,469 (Dec. 12, 2006) (to be codified at 48 C.F.R. parts 216 and 252).

<sup>38</sup> A DCAA official said that, despite the concerns it expressed in official comments on the proposed changes, DCAA concurred with the new rules.

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that they were paying too much for subcontracted labor that was billed at the prime contractor's labor rates. According to the DFAS division chief for contract services, to mitigate this risk on other blanket purchase agreements, DFAS now includes language in the terms and conditions of the agreements specifying that the subcontractor's actual costs shall be billed and that the labor rates in the blanket purchase agreement shall be used for prime contractor labor only.

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## Conclusions

While time-and-materials contracts are appropriate when specific circumstances justify the risks, our findings indicate that they are often used as a default for a variety of reasons—ease, speed, and flexibility—and that the risk posed to the government is not fully taken to heart by contracting and program officials. In our view, these reasons can also be seen as symptomatic of broader problems related to requirements and a focus on awarding contracts quickly. Heightened management controls are needed, including thorough justifications specific to the individual procurements that provide insight to management about why time-and-materials contracts are being used and continue to be used for recurring efforts, even when adequate information is available to convert to a less risky contract type. The FAR Council has recognized the need for more controls to address risks. While we understand that the focus of the new rules was commercial acquisitions, the conditions that called for the stricter controls also apply to non-commercial acquisitions, based on our findings. In addition, without appropriate monitoring of contractor performance when time-and-materials contracts are used, the risk of wasted government dollars is increased.

## Recommendations

To help ensure that all time-and-materials acquisitions receive the appropriate level of oversight, we recommend that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to amend the DFARS to require a similar level of justification for using time-and-materials for non-commercial services as that in the FAR for commercial services by taking the following four actions with regard to non-commercial acquisitions:

1. Require the contracting officer to execute written justifications for each time-and-materials task order issued under an indefinite-quantity contract.
2. Require that written justifications be prepared for indefinite-quantity contracts that allow only for time-and-materials orders.

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3. Require that written justifications for the use of time-and-materials contracts and task orders
    - contain sufficient facts and rationale to justify that no other contract type authorized is suitable;
    - address the specific characteristics of the acquisition that prevent the use of either a cost-reimbursable or fixed-price contract;
    - establish that the requirement has been structured to maximize the use of fixed price contract type on future acquisitions for the same or similar requirements; and
    - describe actions planned to maximize the use of fixed-price contracts on future acquisitions for the same requirements.
  4. Require that contracting officers, to the maximum extent practicable, structure indefinite-quantity contracts to allow issuance of fixed-price or cost-reimbursable orders, so that time-and-materials is not the only option.

To monitor and minimize DOD's use of time-and-materials contracts, we recommend that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to take the following two actions:

1. For indefinite-quantity contracts that permit time-and-materials orders, require heads of contracting activities to analyze on an annual basis whether time-and-materials is being used as a default contract type when other pricing arrangements may be appropriate. The Secretary will need to determine appropriate risk-based criteria to select the contracts for such analysis.
2. Direct that monitoring plans for time-and-materials contracts recognize the risks inherent in this contract type and set forth specific activities to address these risks to the extent feasible.

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## Agency Comments and Our Evaluation

DOD's Office of Defense Procurement and Acquisition Policy provided written comments on a draft of this report. These comments are reprinted in appendix II.

DOD concurred with all six recommendations and has initiated two DFARS cases to consider changes to DOD's acquisition regulations. DOD also stated that it will require military departments and defense agencies to develop plans for analyzing whether time-and-materials contracts are being used as a default contract type. In its response to the recommendations on amending its acquisition regulations to require a

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similar level of justification as is contained in federal acquisition regulations for commercial services, DOD stated that it would evaluate or consider our recommendations during the defense acquisition regulation rulemaking process. While we understand DOD cannot commit to implementing our recommendations in advance of the public comment process, we would expect that the recommendations would be used as the basis for any proposed rules it offers.

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We are sending copies of this report to interested congressional committees; the Secretary of Defense; the Secretaries of the Air Force, the Army, and the Navy; the Administrators of the General Services Administration and Office of Federal Procurement Policy; and the Directors of the Defense Contract Audit Agency, Defense Contract Management Agency, Defense Information Systems Agency, Defense Intelligence Agency, and Office of Management and Budget. We will provide copies to others on request. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report or need additional information, please contact me at (202) 512-4841 or [schinasi@gao.gov](mailto:schinasi@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Staff acknowledgments are listed in appendix III.

A handwritten signature in black ink, appearing to read "Katherine V. Schinasi".

Katherine V. Schinasi  
Managing Director  
Acquisition and Sourcing Management

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# Appendix I: Scope and Methodology

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Our objectives were to (1) identify the overall trends in Department of Defense (DOD) obligations under time-and-materials contracts; (2) analyze what DOD is buying under time-and-materials contracts; (3) assess the factors leading to DOD's use of this contract type and whether actions are being taken to use it only when no other contract type is suitable; (4) evaluate DOD's monitoring of contractor performance under time-and-materials contracts; and (5) determine the differences between the labor rates prime contractors used to bill DOD and the labor rates in their subcontracts, for selected contracts.

To identify trends in the use of time-and-materials contracts, we analyzed obligation data from DOD's DD350 database for service contracts that were identified as either time-and-materials or labor hour contracts between fiscal year 1996 and 2005. The 2005 data was the most recent available. For this period, we examined trends in the contract types used for service acquisitions overall and for specific types of services. During our initial review of the DD350 data, we found that orders under federal schedules did not designate a contract type—a potentially significant limitation for this objective. To address this limitation, we developed an approach to estimate the percentage of these uncoded federal schedule orders that were time-and-materials and labor hour actions. We applied the proportion of obligations reported as time-and-materials for each of the 24 service categories in the DD350 database to the obligations that were missing a contract type (i.e., federal schedule orders). We believe this methodology is conservative because it is likely to underestimate the obligations associated with time-and-materials contracts. Orders for services under federal schedules must be priced on a fixed-price or time-and-materials basis. However, cost-reimbursable contracts comprise 16 percent and 57 percent, respectively, (adjusted to exclude contract dollars in these categories with a missing contract type) of the two service categories—professional services and information technology services—that account for the large majority of contract dollars (78 percent or \$5.4 billion) where contract type is not coded. In developing our estimate, we did not adjust the percentages to account for the fact that cost-reimbursable contracts cannot be used for schedule orders.

To determine the major categories of services where DOD has obligated time-and-materials dollars and the growth in these categories of services over time, we analyzed data from the DD350 database from fiscal year 1996 through fiscal year 2005. We also used information from the DD350 database for fiscal year 2005 to determine the extent to which DOD is obligating time-and-materials dollars under various types of contracts (such as indefinite-quantity contracts). To provide examples of types of

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services DOD is procuring under time-and-materials contracts, apart from that reported in the DD350 system, we analyzed documents in the contract files, such as statements of work and contractor proposals, for the contracts and orders in our review. We also interviewed contracting and program officials.

We derived our sample of 28 contracts, agreements, and orders, analysis of which was used in developing the third and fourth objectives, as follows. During the design phase of our review, we extracted information from the DD350 database on all DOD actions in fiscal years 2004 and 2005 with obligations coded as time-and-materials or labor-hour. This analysis yielded a total of 4,785 actions. We selected seven contracts from this group, taking into account the location of the buying activity and type of contract (e.g., stand-alone, indefinite-quantity, or blanket purchase agreement). We subsequently selected 21 additional contracts and agreements for further detailed review in two steps. First, we selected the three time-and-materials contracts with the most reported obligations in fiscal year 2005. Each of these had over \$300 million in fiscal year 2005 obligations. Second, we selected an additional 18 contracts and agreements from a smaller population of 559 contracts that were coded as time-and-materials and had over \$1 million in cumulative obligations for fiscal year 2005. We made these selections randomly within groups based on type of contract/order, origin of contract, location of buying activity, and military service or “other DOD” organization.

Of the 28 contracts and agreements in our sample, 21 used orders as the mechanism for putting work on contract.<sup>1</sup> For 18 of the 19, we chose 3 orders to analyze as well. For the other, we examined the one order with time-and-materials obligations recorded in fiscal years 2004 and 2005. To further verify the DD350 data for the contracts we reviewed, we compared the reported information with documents in the contract files and found one order that had been miscoded as time-and-materials. We removed this order from the sample. Cumulatively, we reviewed a total of 82 contracts, agreements, and orders.

The following table presents basic information about the 28 contracts, agreements, and orders in our sample.

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<sup>1</sup> Nineteen were DOD contracts, one was a General Services Administration governmentwide acquisition contract, and one was a National Institutes of Health governmentwide acquisition contract.

**Table 6: Characteristics of GAO's Sample of 28 Contracts, Agreements, and Orders**

<b>Organizations</b>	<b>Number in our sample</b>	<b>Obligated dollars through fiscal year 2005</b>	<b>Number in our sample</b>
Air Force	7	Over \$1 billion	2
Army	8	\$1 billion to \$500 million	1
Defense Contract Management Agency	1	\$500 million to \$100 million	3
Defense Information Systems Agency	2	\$100 million to \$50 million	5
Defense Intelligence Agency	2	\$50 million to \$10 million	8
Navy	8	Less than \$10 million	9

<b>Types of services</b>	<b>Number in our sample</b>	<b>Types of contract vehicles</b>	<b>Number in our sample</b>
Engineering and technical support	12	Indefinite-quantity contract	13
Information technology	11	Standalone contract	5
Maintenance of equipment	3	Order off a schedule or governmentwide acquisition contract	4
Miscellaneous professional, administrative, and management support	2	Blanket purchase agreement	4
		Basic ordering agreement	1
		Requirements contract	1

Sources: Contract file documentation and DOD DD350 database (data); GAO (analysis).

To assess the actions DOD officials have taken to ensure time-and-materials contracts are only used when no other contract type is suitable, we reviewed applicable acquisition policies and regulations to identify governmentwide and DOD-specific criteria on when and how they should be used. We also held discussions with acquisition policy officials at the Air Force, Army, Navy, Defense Information Systems Agency, Defense Intelligence Agency, and Defense Contract Management Agency to determine how each organization commonly utilized time-and-materials contracts and how they monitored the extent of their use. In addition, for each of the contracts in our sample, we reviewed acquisition documentation including the determination and findings, if available; acquisition plans; and business clearance memorandums to assess what factors were considered to determine and justify the use of the contract type. We also interviewed contracting officers and, in some cases, program officials to discuss the rationale used to support the decision to use a time-and-materials contract and the reasons this contract type was eventually chosen.

To evaluate the government's monitoring of contractor performance, we reviewed documentation of contract monitoring for each of our sample contracts. This documentation included monitoring plans, contractor-generated monthly status reports, government-generated contractor performance reports, and sample invoices. We used these documents to assess what measures were taken to monitor contractor performance and to what extent those measures were executed and documented in the contract file. We also interviewed the designated contracting officer's representative and/or other individuals responsible for monitoring to corroborate and supplement the information in the contract file.

To collect contract file documents and conduct interviews related to the use and monitoring of the time-and-materials contracts in our sample (our third and fourth objectives), we visited the following locations:

**Air Force:**

Air Force 11th Contracting Wing, Bolling Air Force Base, Washington, D.C.  
Air Force 554th Electronic Systems Group, Wright-Patterson Air Force Base, Dayton, Ohio

Air Force 951st Electronic Systems Group, Hanscom Air Force Base, Mass.  
Air Force Aeronautical Systems Center, Wright-Patterson Air Force Base, Dayton, Ohio

Air Force Air Logistics Center, Tinker Air Force Base, Oklahoma City, Okla.

Air Force Cost Analysis Agency, Arlington, Va.

National Air and Space Intelligence Center, Wright-Patterson Air Force Base, Dayton, Ohio

**Army:**

Army Aviation and Missile Command, Redstone Arsenal, Huntsville, Ala.  
Army Communications-Electronic Command, Fort Monmouth, N.J.

Army Communications-Electronics Research, Development and Engineering Center, Fort Belvoir, Va.

Army Contracting Center of Excellence, Washington, D.C.

Army Information Technology, E-Commerce and Commercial Contracting Center, Alexandria, Va.

Department of the Army, G-8 Programs and Priorities, Washington, D.C.

**Navy:**

Naval Air Systems Command, Patuxent River, Md.  
Naval Sea Systems Command, Washington Navy Yard, D.C.  
Naval Surface Warfare Center Carderock Division, West Bethesda, Md.

**Other DOD:**

Defense Contract Management Agency, Springfield, Va.  
Defense Intelligence Agency, Washington, D.C., and Arlington, Va.

We were able to obtain contract files from the Defense Information Systems Agency electronically. We conducted additional interviews by video conference or telephone.

For the final objective on prime contract labor rates billed for subcontracted labor, we first analyzed the 28 contracts, agreements, and orders in our sample to determine which permitted prime contractors to charge the government for subcontracted labor using their own, prime contract rates. We collected information on the difference between the prime and subcontract labor rates for one of the blanket purchase agreements in our sample. We then selected an additional 12 contracts and agreements for further, detailed review of the labor rates, based on congressional interest, for a total of 13 contracts and agreements to address this objective. We identified these additional 12 contracts and agreements from two sources. First, since the Defense Contract Audit Agency had identified this billing practice as an issue primarily with orders under General Services Administration schedule contracts, we examined DOD's blanket purchase agreements under schedule contracts as reported in the DD350 database and selected six for further analysis. Second, we analyzed contracts that had been reviewed by DOD as a result of Sections 801 and 802 of the National Defense Authorization Act for Fiscal Year 2002 to identify those that had reported time-and-materials obligations, and selected six of these for further analysis. Because all 13 contracts and agreements we reviewed under this objective were structured to allow task orders to be issued under them, we selected orders from each to analyze. In all, we assessed the differential between the prime and subcontract labor rates for 24 task orders and 628 different labor categories within those orders. We analyzed contract documentation and interviewed prime contractors about the labor rates used to bill DOD for subcontracted labor. We queried Defense Contract Audit Agency about audit assignments it has conducted where it found this billing practice. We also reviewed recent revisions to the Federal Acquisition Regulation and

DOD's supplement pertaining to how prime contractors can bill the government for subcontracted labor and discussed these revisions with officials from DOD's Procurement and Acquisition Policy office.

We performed our review from February 2006 to May 2007 in accordance with generally accepted government auditing standards.

# Appendix II: Comments from the Department of Defense



ACQUISITION,  
TECHNOLOGY  
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE  
3000 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3000

JUN 29 2007

Ms. Katherine V. Schinasi  
Managing Director, Acquisition and Sourcing Management  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Schinasi:

This is the Department of Defense (DoD) response to the GAO draft report, GAO-07-273, "DEFENSE CONTRACTING: Improved Insight and Controls Needed over DoD's Time-and-Materials Contracts," dated June 1, 2007, (GAO Code 120512).

I appreciate the opportunity to comment on the draft report. I concur with the GAO recommendations as discussed in the enclosure. I have opened two Defense Federal Acquisition Regulation Supplement (DFARS) cases to develop necessary changes to the DFARS and any additional supplemental guidance that may be appropriate for procedures, guidance, and information. I anticipate issuance of the proposed rules and/or supplemental guidance within 180 days.

Additionally, I will issue direction within the next 60 days to require the military departments and other defense agencies to develop plans for analyzing whether time-and-materials contracts are being used as a default contract type when other pricing arrangements may be appropriate.

If you have any questions or require additional information, please contact Ms. Robin Schulze, 703-602-0326, [robin.schulze@osd.mil](mailto:robin.schulze@osd.mil).

Sincerely,

A handwritten signature in black ink, appearing to read "Shay D. Assad".

Shay D. Assad  
Director, Defense Procurement  
and Acquisition Policy

Attachments:  
As stated



GAO Draft Report Dated JUNE 1, 2007  
GAO-07-273 (GAO CODE 120512)

**"DEFENSE CONTRACTING: IMPROVED INSIGHT AND CONTROLS  
NEEDED OVER DOD'S TIME-AND-MATERIALS CONTRACTS"**

**DEPARTMENT OF DEFENSE COMMENTS  
TO THE GAO RECOMMENDATIONS**

**RECOMMENDATION 1:** The GAO recommends that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to amend the DFARS to require a similar level of justification for using time-and-materials for non-commercial services as that in the FAR for commercial services by requiring the contracting officer to execute written justifications for each time-and-materials task order issued under an indefinite-quantity contract.

**DOD RESPONSE:** Concur. The Department has opened a DFARS case to evaluate, for T&M contracts for non-commercial services, whether the DFARS should be amended to require a written determination and finding (D&F) for each time-and-materials task order issued under an indefinite-quantity contract that provides for orders priced on both a time-and-materials basis and orders priced on another contract type basis, i.e., fixed-price, cost reimbursement, and incentive contracts. DPAP will keep the GAO apprised of the progress of this case as it moves thru the regulatory process.

**RECOMMENDATION 2:** The GAO recommends that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to amend the DFARS to require a similar level of justification for using time-and-materials for non-commercial services as that in the FAR for commercial services by requiring that written justifications be prepared for indefinite-quantity contracts that allow only for time-and-materials orders.

**DOD RESPONSE:** Concur. As part of the DFARS case referenced in our response to Recommendation 1, the Department will evaluate, for T&M contracts for non-commercial services, whether the DFARS should be amended to require D&Fs supporting basic indefinite-delivery contracts that only provide for time-and-material orders to explain why it is not practicable for the contract to also provide for orders on a fixed-price, cost reimbursement, and/or incentive contract basis. The case will also consider whether the DFARS should be amended to require that the D&F to be approved one level above the contracting officer, for the D&F to document why other pricing structures are not practicable, and to require higher level approval to increase the emphasis on selecting the appropriate contract type that results in reasonable contractor

risk and provides the contractor with the greatest incentive for efficient and economical performance. DPAP will keep the GAO apprised of the progress of this case as it moves thru the regulatory process.

**RECOMMENDATION 3:** The GAO recommends that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to amend the DFARS to require a similar level of justification for using time-and- materials for non-commercial services as that in the FAR for commercial services by requiring that written justifications for the use of time-and-materials contracts and task orders:

- a) Contain sufficient facts and rationale to justify that no other contract authorized is suitable;
- b) Address the specific characteristics of the acquisition that prevent the use of either a cost-reimbursable or fixed-price contract;
- c) Establish that the requirement has been structured to maximize the use of fixed price contract type on future acquisitions for the same or similar requirements; and
- d) Describe actions planned to maximize the use of fixed-price contracts on future acquisitions for the same requirements.

**DOD RESPONSE:** Concur. As part of the DFARS case referenced in our response to Recommendation 1, the Department will consider, for T&M contracts for non-commercial services, whether to amend the DFARS to require D&Fs for time-and-materials contracts and task orders to:

- a) Contain sufficient facts and rationale to justify that no other contract type is suitable;
- b) Establish that it is not possible at the time of placing the contract or order to accurately estimate the extent or duration of the work or to anticipate costs with any reasonable degree of certainty;
- c) Establish that the requirement has been structured to maximize the use of firmer pricing (i.e., cost-reimbursement, incentive, and fixed-price contracts) on future acquisitions for the same or similar requirements; and
- d) Describe actions planned to maximize the use of firmer pricing on future acquisitions for the same requirements.

**RECOMMENDATION 4:** The GAO recommends that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to amend the DFARS to require a similar level of justification for using time-and- materials for non-commercial services as that in the FAR for commercial services by requiring the contracting officer, to the maximum extent practicable, structure indefinite-quantity contracts to allow issuance of fixed-price or cost reimbursable orders, so that time-and-materials is not the only option.

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**Appendix II: Comments from the Department  
of Defense**

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**DOD RESPONSE:** Concur. As part of the DFARS case referenced in our response to Recommendation 1, the Department will consider, for T&M contracts for non-commercial services, amending the DFARS to require indefinite-quantity contracts to be structured, to the maximum extent practicable, to also provide for issuance of other contract types. The Department agrees it may be appropriate to provide for multiple contract types on indefinite-delivery contracts to ensure use of the appropriate contract type for the unique circumstances of the acquisition.

**RECOMMENDATION 5:** The GAO recommends that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to require heads of contracting activities to analyze on an annual basis whether time-and-materials is being used as a default contract type when other pricing arrangements may appropriate.

**DOD RESPONSE:** Concur. The Department will require the military departments and other defense agencies to establish review plans for analyzing whether time-and-materials contracts are being used as a default contract type when other pricing arrangements may appropriate.

**RECOMMENDATION 6:** The GAO recommends that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to direct that monitoring plans for time-and-materials contracts recognize the risks inherent in this contract type and set forth specific activities to address these risk to the extent feasible.

**DOD RESPONSE:** Concur. The Department has opened a DFARS case to (a) describe the roles and responsibilities of contracting officers technical representatives (COTRs) for managing risks on time-and-materials and other cost reimbursement contracts and (b) ensure Government surveillance on time-and-materials contracts provides the Government reasonable assurance that efficient methods and effective costs controls are being used. DPAP will keep the GAO apprised of the progress of this case as it moves thru the regulatory process.

# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Acknowledgments

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In addition to the contact listed above, Michele Mackin, Assistant Director; Ron Schwenn; Marie Ahearn; Nicholas Alexander; Elaine Boudreau; Lily J. Chin; Paula J. Haurilesko; Art James; Matt Keeler; Julia Kennon, and Patrick Peterson made key contributions to this report.

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